

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 03-0277
Gross Income & Adjusted Gross Income Tax
For the Years 1998, 1999, 2000**

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ISSUE

I. Adjusted Gross Income Tax—Intangible Holding Companies

Authority: Ind. Code § 6-3-2-2; Ind. Code § 6-3-2-2.4; Ind. Code § 6-8.1-5-1; *Chief Industries v. Ind. Dep't of Revenue*, 792 N.E.2d 972 (Ind. Tax 2000); *Bethlehem Steel Corp. v. Ind. Dept. of State Revenue*, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992); *Allied-Signal Corp. v. Director, Division of Taxation*, 504 U.S. 768 (1992); *F.W. Woolworth Co. v. Taxation and Revenue Dep't. of New Mexico*, 458 U.S. 354 (1982); *Exxon Corp. v. Dept. of Revenue of Wisconsin*, 447 U.S. 207 (1980); *Gregory v. Helvering* 293 U.S. 465 (1935); *Lee v. Commissioner of Internal Revenue*, 155 F.2d 584, 586 (2d Cir. 1998); *Horn v. Commissioner*, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992); *Commissioner v. Transp. Trading and Terminal Corp.*, 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied*, 338 U.S. 955 (1950); *Zebra Technologies Corp. v. Topinka*, 799 N.E.2d 725 (Ill. Ct. App. 2003); *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993).

Taxpayer maintains that the Department of Revenue erred when it recomputed taxpayer's adjusted gross income to include an affiliated company on a unitary basis.

II. Gross Income Tax—Taxability of Intangibles

Authority: Ind. Code § 6-2.1-4-6; 45 IAC 1.1-6-2.; *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993).

Taxpayer protests the assessment of gross income tax with respect to royalties paid to a related taxpayer located outside the United States.

III. Tax Administration--Penalty

Authority: 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the ten percent penalty for negligence.

STATEMENT OF FACTS

Taxpayer is an out-of state company in the business of selling automobile supplies at retail stores throughout the United States, including Indiana. In the fiscal year ending in 1998, taxpayer transferred certain trademarks and its trade name to a wholly owned subsidiary (“Subsidiary”) based in the Cayman Islands. Taxpayer in turn paid Subsidiary in exchange for the right to use the trademarks that Taxpayer previously owned, which Taxpayer then licensed to yet another subsidiary that consisted of its stores. Taxpayer had considerable property in Indiana, while Subsidiary did not maintain employees or offices in Indiana.

Department audited taxpayer’s Indiana corporate income tax returns for taxable years 1998, 1999 and 2000. As a result of the audit, Department made several adjustments to the taxpayer’s returns for both gross income and adjusted gross income tax purposes. For gross income tax purposes, Subsidiary was assessed gross income tax, based on the theory that the intangibles had acquired an Indiana situs, and not exempt for intracompany deduction because Subsidiary was not registered for business in Indiana. For adjusted gross income tax purposes, Taxpayer and Subsidiary were combined as a unitary filer. Taxpayer filed a protest, claiming that the Department could not constitutionally tax the intangible income either for gross income tax or for adjusted gross income tax.

I. Adjusted Gross Income Tax—Intangible Holding Companies

DISCUSSION

With respect to adjusted gross income, Taxpayer raises the issues of whether the royalty income can even be subject to Indiana adjusted gross income tax and whether the Department can require a unitary filing of two or more taxpayers in this case. In the alternative, the issues of whether the transaction is a sham transaction and if Subsidiary itself was subject to taxation on the basis of having Indiana situs must be addressed.

A. Applicability of Chief Industries

The first argument presented by Taxpayer is that the income from Subsidiary’s royalties is not subject to taxation in Indiana based on the Tax Court’s holding in *Chief Industries v. Ind. Dep’t of Revenue*, 792 N.E.2d 972 (Ind. Tax 2000). However, it is difficult to understand Taxpayer’s argument with respect to the royalties under the generally accepted statutory scheme provided by 6-3-2-2(a)-(k) - that is, whether it was business or non-business income, and whether the sales, payroll and property of the taxpayer were apportionable to Indiana in the case of business income or the income was allocable to Indiana in the case of non-business income. In this light, Taxpayer’s argument does not address this issue, and accordingly must fail.

B. Sham transaction

The “sham transaction” doctrine is well established both in state and federal tax jurisprudence dating back to *Gregory v. Helvering* 293 U.S. 465 (1935). In that case, the Court held that in

order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. *Id.* at 469. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and “[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.” *Id.* at 470. The courts have subsequently held that “in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.” *Commissioner v. Transp. Trading and Terminal Corp.*, 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied*, 338 U.S. 955 (1950). “[t]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer’s desire to secure the attached tax benefit” but are devoid of any economic substance. *Horn v. Commissioner*, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; “(1) did the transaction have a reasonable prospect, *ex ante*, for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?” *Id.* at 1237.

The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual one. *Lee v. Commissioner of Internal Revenue*, 155 F.2d 584, 586 (2d Cir. 1998). The taxpayer has the burden of demonstrating that the subject transaction was entered into for a legitimate business purpose. Ind. Code § 6-8.1-5-1(b).

Here, it is difficult if not impossible to ascertain a business purpose for the arrangement between Taxpayer and Subsidiary. Taxpayer transferred the intellectual property that it created to Subsidiary, which licenses that property only to Taxpayer. Miraculously, Taxpayer had only a relatively modest profit from its operations of auto part retailers, but Subsidiary generated substantial profits from licensing some names and logos to nobody but their prior owner, and maintained only a small office on a Caribbean island. The shareholders of Taxpayer looked at the bottom line and saw no overall difference in the companies’ operating performance. To state that Taxpayer’s names and logos derived a value separate from its underlying business comports neither with reality nor common sense.

By permitting Taxpayer the deduction it claimed for adjusted gross income tax purposes is to exact a violence on the term “fairly allocate,” per Ind. Code § 6-3-2-2(l) that can only be corrected by reallocating the income between Taxpayer and Subsidiary. Accordingly, the deduction for the payment to Subsidiary-the sham transaction in this case-is disallowed.

Taxpayer is, of course, entitled to structure its business affairs in any manner its sees fit and to vigorously pursue any tax advantage attendant upon the management of those affairs. However, in determining the nature of a business transaction and the resultant tax consequences, the Department is required to look at “the substance rather than the form of the transaction.” *Bethlehem Steel Corp. v. Ind. Dept. of State Revenue*, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992). The transfer of the intellectual property and the royalty payments were purely matters of “form” and lack any business “substance.”

C. Unitary filing

The second issue to be addressed is whether Taxpayer and Subsidiary can properly be combined on a unitary return. Under Ind. Code § 6-3-2-2(l),

If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of any one (1) or more of the factors;
- (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

In addition, Ind. Code § 6-3-2-2(m) states:

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In the case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

Subsidiary was a wholly owned subsidiary of Taxpayer, so common control was not at issue. Thus, the issue remains as to whether Taxpayer and Subsidiary in fact constituted a unitary business.

To look at whether a taxpayer and subsidiary comprise a unitary business, one must look at the (1) functional integration; (2) centralization of management; and (3) economies of scale. *Allied-Signal Corp. v. Director, Division of Taxation*, 504 U.S. 768, 781 (1992) (citing *F.W. Woolworth Co. v. Taxation and Revenue Dep't. of New Mexico*, 458 U.S. 354, 364 (1982)). In order to exclude certain income from the apportionment formula, the company must prove that "the income was earned in the course of activities unrelated to the sale of [property] in that State." *Exxon Corp. v. Dept. of Revenue of Wisconsin*, 447 U.S. 207, 223-224 (1980) (citing *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 439 (1980)). One "looks to the "underlying economic realities of a unitary business," and the income must derive from "unrelated business activity" which constitutes a "discrete business enterprise,"" *Mobil*, 445 U.S. at 439, 441-442.

With respect to functional integration, in *F.W. Woolworth*, the court noted that the operation of taxpayer and four foreign subsidiaries who maintained separate operations failed to constitute functional integration necessary to permit unitary taxation. 458 U.S. at 364-365. Here, Taxpayer wholly owns Subsidiary. Taxpayer paid royalties for the right to use trademarks owned by Subsidiary. Taxpayer and Subsidiary received income only when Taxpayer sold auto parts. Even with the royalty-payment transaction, nothing changed with respect to the taxpayer's overall business- Taxpayer acknowledged in Securities & Exchange Commission filings for

several years that the trademarks now held by the new corporation were “important components of our merchandising and marketing strategy” before AND AFTER the formation of Subsidiary. One of two inferences can be made from this: either the names aren’t so important to Taxpayer that it can allow Subsidiary to use it even to the detriment of Taxpayer, or the two companies are *de facto* one enterprise.

Further, even though the companies had some different managers, the companies had the same key executives. Accordingly, Taxpayer and Subsidiary met this requirement of unitary filing.

With respect to economies of scale, the company has not provided any evidence that the auditor’s determination was incorrect. Further, with respect to any economies of scale, it would appear that Taxpayer, by virtue of not having to incur the expense of additional officer compensation and of additional costs associated with actual licensing agreements with third parties, achieved the necessary economies of scale. In the alternative, Subsidiary managed to generate several million dollars out of a single office—a ratio far greater than its revenue-to-marginal expense ratio likely found at its retail stores, achieving the necessary economies of scale.

Finally, with respect to fair representation of income, Taxpayer’s transaction can only be described as not fairly representing Taxpayer’s income. Taxpayer received a substantial profit from its stores’ sales of automobile parts, only to have it greatly reduced by using its own name for a substantial sum of money. Both businesses, if respected as businesses, constituted an integrated enterprise, and to state that only the portion due to its primary automobile parts business was taxable, without recognizing the whole of the enterprise to overall profitability, was to not fairly represent Taxpayer’s income in Indiana.

Taxpayer also noted that its subsidiary was located in a foreign country, and therefore it should be exempt under Ind. Code § 6-3-2-2(o), which provides that a foreign corporation or foreign operating company cannot be combined under subsections (l) and (m). A foreign operating company is defined by Ind. Code § 6-3-2-2.4(a) as being a company which has 80% or more of its business activity outside the United States. A business meets the criteria if its United States property factor (defined as United States property over worldwide property) and its United States payroll factor (defined as United States payroll over worldwide payroll), added together, divided by 2, is greater than or equal to 0.80. IC 6-3-2-2.4

Only one court has dealt with the situation presented by the Taxpayer and Subsidiary in this case with respect to an intangibles holding company located in a foreign country. In *Zebra Technologies Corp. v. Topinka*, 799 N.E.2d 725 (Ill. Ct. App. 2003), a company engaged in the business of manufacturing bar-coding equipment formed another corporation, incorporated in Bermuda to which it transferred its intellectual property. Taxpayer maintained that the corporation was not subject to forced unitary filing based on an Illinois statute similar to Ind. Code § 6-3-2-2(o). In particular, the taxpayer argued that the company had no payroll or property in the United States, and therefore was precluded from forced unitary filing. The court, however, noted that much of the work related to the intellectual property actually occurred in the United States, held that the company in question was not a foreign operating company, and therefore subject to unitary filing. *Id.* at 732-734.

Here Taxpayer was presented with an opportunity to address this issue during hearing and in the period after the hearing Taxpayer was presented an additional opportunity to gather information. Taxpayer has not presented information other than its statement that the Subsidiary was a foreign operating company and a note that the case cited above was not an Indiana case, without further information regarding exploitation of the intellectual property either in the United States or elsewhere. Accordingly, Taxpayer's burden to show that the company was in fact a foreign operating company has not been met.

D. Subsidiary has Indiana situs

Even if the subsidiary was not a unitary taxpayer, Subsidiary's income was Indiana source income when it engaged in transactions related to "exploiting" intellectual property.

Here, the case *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993), though not controlling, is quite persuasive. In that case, a large toy company established a company to which it transferred its trademarks. The toy company paid a percentage of its sales to the trademark holding company. The trademark holding company was located in Delaware, but had no employees. *Id.* at 15, n.1. The toy company claimed a deduction for its royalty payments to the holding company for South Carolina corporate income tax purposes, but claimed that none of the royalty payments were South Carolina source income. South Carolina claimed that the holding company had conducted business in South Carolina, while the holding company claimed that taxation of its royalty income by South Carolina was prohibited by the federal constitution. The court noted that the holding company had nexus with South Carolina, via the purposeful opening of stores in South Carolina and the toy company's sales of merchandise at its South Carolina stores, through which the holding company derived its revenues. *Id.* at 16-18. Accordingly, the court held that the taxation of the holding company's income was permissible under the United States Constitution and South Carolina law.

Subsidiary was engaged of managing intellectual property-property that has no value apart from Taxpayer's sales of merchandise. To state that the intangible income derived from the licensing transactions only took place in the Cayman Islands, in an office with a telephone, fax machine, computer and some furniture, did not fairly represent the transaction between Taxpayer and Subsidiary. Taxpayer sold automobile products for a business, in this state, almost every other state, and a few foreign countries. Taxpayer derived the benefit of sales made in Indiana stores of its services and parts. To state that the royalty income was income derived only from the Cayman Islands was to very conveniently ignore that the sales and service that made the taxpayer a veritable household name occurred in many states other than the Cayman Islands (where, interestingly, Taxpayer did not even have a store), and that Subsidiary's own revenues for the royalties necessarily derived from the sales that transpired in many states and countries, rather than just the Cayman Islands.

FINDING

Taxpayer's protest is denied.

II. Gross Income Tax— Taxability of Intangibles

DISCUSSION

Taxpayer protests the imposition of gross income tax with respect to its royalty payments made to a related taxpayer located in the Cayman Islands.

In this case, three issues must be resolved:

1. Did the taxpayer have an Indiana situs for its intangibles?
2. Is the taxpayer a unitary filer?
3. Is the whole transaction a sham transaction?

With respect to situs, taxpayer argues that the intangibles formed an integral part of a trade or business situated and regularly conducted outside Indiana, noting the location of its intangibles in the Cayman Islands. Accordingly, under Department regulations, the intangible income should be attributed to that location.

However, it cannot be said that this is an entirely accurate assessment of the taxpayer's arrangement. Taxpayer's arrangement basically works in this manner: Taxpayer's store subsidiary made a sale of auto parts at its store. Taxpayer in turn took the money and paid to Subsidiary a percentage of that money for the "right" to use Taxpayer's own name. By virtue of its control of Taxpayer's name and its exploitation in Indiana, Subsidiary acquired an Indiana situs.

Taxpayer argues that the auditor's reliance on the *Geoffrey* case cited previously is misplaced, first by noting that the case was decided in another state, and second by noting the regulations stated above. While *Geoffrey* is persuasive rather than mandatory authority in Indiana, the reasoning that the intangible has situs in this circumstance is worthy of discussion. In the current case, Subsidiary only derived income upon the sale of goods at its stores. This is very similar to the intangible holding company in *Geoffrey*, which the court noted derived its income not from the mere holding of a piece of paper, but rather from retail transactions that the retailer purposely sought. Further, unlike a conventional franchise arrangement in which a holder of a name agrees to allow unrelated third parties to use its name, Subsidiary transacted business only with Taxpayer. To the extent that the subsidiary yielded its "royalties" as a result of Indiana sales, the intangible formed an integral part of a business regularly carried on in Indiana; thus, the intangibles had a business situs in Indiana, and accordingly were properly subject to Indiana gross income tax. 45 IAC 1.1-6-2. Further, because Subsidiary was not authorized to do business in Indiana, the deduction under Ind. Code § 6-2.1-4-6 for transfers between affiliated corporations filing consolidated returns was not permitted.

If Taxpayer and Subsidiary were in fact a unitary business, the same result is reached. Finally, given that no exemption or deduction exists for gross income received in a sham transaction, then the income was still taxable, notwithstanding the disregard for the transaction otherwise for tax purposes.

FINDING

Taxpayer's protest is denied.

III. Tax Administration--Penalty

DISCUSSION

Taxpayer argues that it is not subject to negligence penalties with respect to the additional taxes assessed against it. In particular, Taxpayer argues that the additional tax was due to its different, but reasonable, interpretation of the statute. Accordingly, it argues that it was not negligent in its tax returns for the years in question.

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. Ind. Code § 6-8.1-10-2.1. The Indiana Administrative Code further provides:

(b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

(c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

45 IAC 15-11-2.

Taxpayer has acted in a manner with respect to the tax laws of this state that leads the Department to believe that its actions were a negligent disregard of those laws at best. Accordingly, the penalty must stand.

FINDING

Taxpayer's protest is denied.

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